

# Hoosier Lottery

## Request for Lottery License Qualifications

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**JANUARY 2, 2007**

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## **I. OVERVIEW OF RFQ AND LICENSING PROCESS:**

### **Introduction**

The Indiana Finance Authority (the “Authority”), on behalf of the State of Indiana (the “State”) has engaged Morgan Stanley (the “Advisor”) as its financial advisor to assist in evaluating the possible fixed-term license (the “License”) of the Hoosier Lottery (the “Lottery”). The Authority’s primary objective is to maximize value to the State while maintaining the high standards, service levels and security of the Lottery. The proceeds of the up-front License payment and any supplemental revenue sharing will be put towards higher education in the State of Indiana, specifically to create a new scholarship program for top Hoosier students who remain in-State after graduation, as well as a fund that will enhance the State’s key knowledge-based industries by bringing world-class researchers and scholars to Indiana’s public universities.

### **Overview of Request for Qualifications (“RFQ”)**

This RFQ allows prospective bidders to formally express their interest in bidding on the License to the Lottery. Sections II and III of this RFQ provide an introductory description of the Lottery and include highlights of the possible License. Section IV summarizes the required bidder qualifications. Section V lists the RFQ submission requirements and currently anticipated procedures for those seeking to bid on the License.

For the purposes of this RFQ, the following definitions will apply:

- “Team” or “Bidder” means an individual, a company, or a consortium of individuals and/or companies formed to undertake the transaction.
- “Team Member” means a member of a Team.

Those interested in bidding on the License should respond to this RFQ no later than 5:00pm Eastern Standard Time on Monday, January 29, 2007. The Authority may determine in its discretion whether to accept any responses that are not received by the date and time set forth in this paragraph. Based on the RFQ submissions, the Authority will determine those Teams that are qualified to bid on the License. There will be no restriction as to the number of Bidders that may qualify.

### **Overview of Bidding and License Process**

After the Authority’s review of RFQ submissions, Bidders that are deemed qualified by the Authority will sign a Confidentiality Agreement and receive a Confidential Information Memorandum providing additional information on the Lottery and the bidding process. Qualified Bidders may be asked to submit preliminary, non-binding bids for evaluation. Bidders accepted for due diligence will have the opportunity to conduct due diligence of the Lottery through: (i) access to an on-line data room; (ii) management presentations and additional inspections by Bidder representatives; and (iii) review and discussion of the Authority’s proposed Lottery License Agreement (the “License Agreement”). Following the due diligence process, final and binding bids will be submitted in accordance with procedures to be provided to the remaining Bidders. Bidders may be required to comply with certain other requirements before submitting final bids.

If the final and binding proposals received at the conclusion of the solicitation process meet the Authority’s objectives, and therefore the State’s objectives, the Authority expects to enter into the License Agreement with the successful Team (the “Operator”). The Authority reserves the right to modify or terminate this solicitation or the bid procedures at any stage if the Authority determines this action to be in its best interests. The receipt of proposals or other documents at any stage of either the RFQ or bidding process will in no way obligate the Authority to enter into any contract of any kind with any party.

The License Agreement will be a fixed-term agreement granting the Operator the exclusive right to operate the Lottery and to collect Lottery revenues (subject to quarterly license payments to the State) during the term of the License Agreement, anticipated to be 30 years. The License Agreement will include operating standards related to the operation, maintenance, security and revenue collection of the Lottery with which the Operator will be required to comply. Currently, the State envisions the form of the compensation for the agreement to consist of a combination of upfront and ongoing license payments. The final form of the payment may be amended as the process proceeds.

## II. LOTTERY DESCRIPTION:

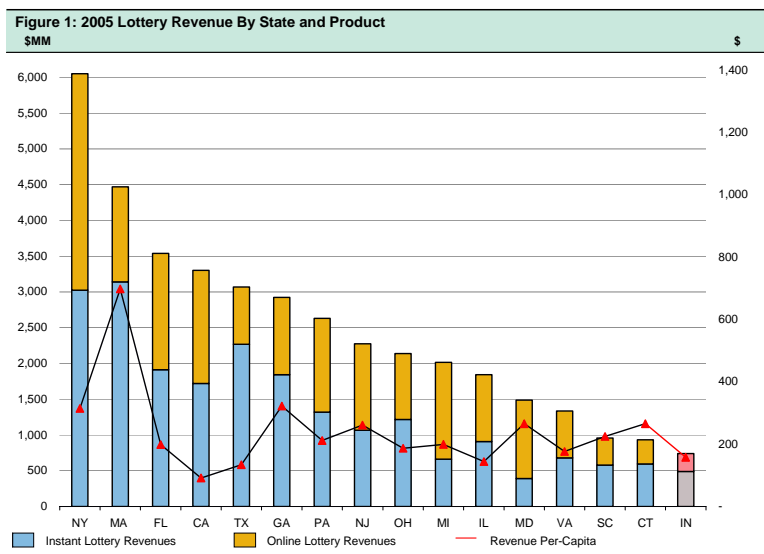
### Overview of the Lottery

The Hoosier Lottery is currently operated by the State Lottery Commission of Indiana. Due to legislative restrictions on gaming within the State of Indiana, the Lottery has significant barriers to entry and is the only State-sanctioned lottery gaming franchise. The Lottery is comprised of both Online and Instant games, with Instant games (“scratch-off games” and “pull tabs”) comprising approximately 64% of total revenue for the fiscal year ending June 30, 2006. Online games include Powerball, Hoosier Lotto, Daily Draw Games, and Mix and Match.

Currently, Scientific Games Corporation (“Scientific Games”) provides Online and Instant lottery services to the Hoosier Lottery and is the Lottery’s largest vendor.

Since its inception in 1989, the Hoosier Lottery has raised almost \$3.0 billion in aggregate to support programs designated by the Indiana General Assembly.

An overview of the Lottery’s revenue and revenue per capita is illustrated to the right in Figure 1.



Source: Morgan Stanley

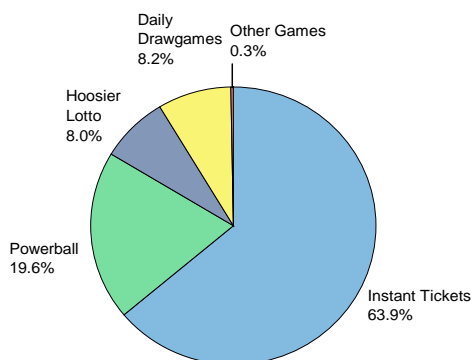
## Overview of Sales

The Lottery has consistently experienced high growth in ticket sales, with historical Earnings Before Interest, Taxes, Depreciation and Amortization (“EBITDA”) margins of over 25% and a 5-year Compound Annual Growth Rate (CAGR) of 8%. Revenues in FY 2006 were \$816 million with approximately \$220 million in EBITDA. Instant ticket sales provide a significant percentage of the Lottery’s revenue stream. The growth in Instant ticket sales has also been the primary driver behind overall Lottery revenue growth, which experienced a 5-year CAGR of 8%. Growth in Instant ticket sales was 11% from FY 2004 to FY 2005 and 6.5% from FY 2005 to FY 2006.

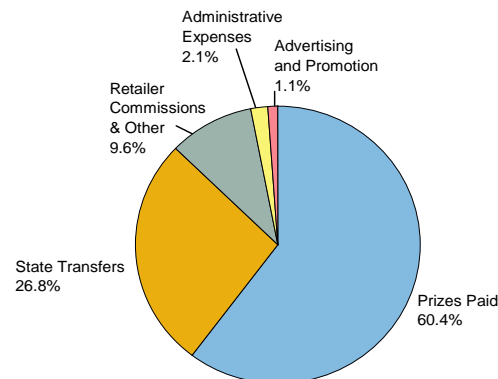
Online games including Powerball, Hoosier Lotto, Daily Draw Games and Mix and Match make up the majority of the remaining ticket sales. In FY 2005, Powerball sales decreased, primarily due to the absence of large jackpots over \$150 million. In an effort to mitigate future Online declines, the Lottery and the governing body of Powerball, the Multi-State Lottery Association, began an initiative to implement operational changes to Powerball that encourage larger and faster growing jackpots, an increase in the powerplay component of the game, and increased advertising. The positive impact of these efforts was witnessed in FY 2006, with Powerball sales increasing by 33% from \$120 million to \$160 million.

The breakdown of FY 2006 Lottery ticket sales and expenses can be found below in Figure 2.

**Figure 2: FY 2006 Hoosier Lottery Ticket Sales**  
\$Mm



**Figure 3: FY 2006 Hoosier Lottery Proceeds Uses**  
\$Mm



Source  
1. 2006 Annual Report – Indiana State Lottery

## Overview of Operating Expenses

As outlined in Figure 3 above, Lottery prizes are the primary component of operating expenses, making up approximately 60% of revenues. Prize expenses increased by 8% from FY 2005 to FY 2006, primarily due to a similar increase in overall ticket sales. Lottery sales are procured through a network of retailers, whose commissions and bonuses comprise approximately 10% of Lottery operating expenses. Retailer-related expenses also increased in FY 2006 due to the overall increase in Lottery ticket sales. Salaries, benefits, and general and administrative expenses in FY 2006 remained flat compared to FY 2005. Overall, EBITDA margins increased to 27% in FY 2006 versus 25% in FY 2005.

Retailers earn a 6% sales commission on draw games and 5.5% commission on scratch-off and pull tab games. There is a 1% cashing commission for redeeming winning tickets and lesser of 1% or \$100,000 for selling winning jackpot tickets. Quarterly bonuses are also paid based on scratch-off/pull tab sales over the preceding 13-week period.

In addition to its prize, distribution, and administrative expenses, the Lottery maintains service contracts with Scientific Games for both its Online and Instant Games. According to the contract provisions, Scientific Games receives 3.00% of gross Online ticket revenue and 1.3855% of scratch-off ticket revenue. The Lottery also has a contract with Pollard Banknote for the back-up supply and delivery of pull tab tickets. After meeting operating expenses, the remaining Lottery profits help to fund various State programs such as the Build Indiana Fund, the Teacher's Retirement Fund, the Pension Relief Fund, and the Help America Vote Act.

## Historical Financial Performance

The Lottery's historical financial performance since FY 2001 is illustrated in Figure 4.

<b>Figure 4: Historical Lottery Financials (\$000)</b>							
<b>Fiscal Year</b>	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>01-06 CAGR</b>
<b>Operating Revenues</b>							
Online Sales	238,451	273,005	258,914	293,803	249,896	294,757	<b>4.3%</b>
% Growth		14.5%	-5.2%	13.5%	-14.9%	18.0%	
Instant Sales	309,838	353,305	405,503	441,069	489,737	521,605	<b>11.0%</b>
% Growth		14.0%	14.8%	8.8%	11.0%	6.5%	
<b>Total Operating Revenues</b>	<b>548,288</b>	<b>626,310</b>	<b>664,417</b>	<b>734,872</b>	<b>739,633</b>	<b>816,362</b>	<b>8.3%</b>
% Growth		14.2%	6.1%	10.6%	0.6%	10.4%	
<b>Operating Expenses</b>							
Prize Payout	319,483	371,207	396,239	436,531	455,332	493,127	<b>9.1%</b>
Advertising and Promotion	10,339	10,037	10,292	9,453	10,061	8,838	<b>-3.1%</b>
Retailer Commissions & Other	54,630	63,224	66,339	72,896	71,062	78,755	<b>7.6%</b>
Administrative Expenses	15,980	16,809	17,167	17,705	17,422	17,228	<b>1.5%</b>
<b>Total Operating Expenses</b>	<b>400,432</b>	<b>461,276</b>	<b>490,038</b>	<b>536,584</b>	<b>553,877</b>	<b>597,948</b>	<b>8.3%</b>
% Growth		15.2%	6.2%	9.5%	3.2%	8.0%	
Depreciation/Amortization	1,095	861	1,479	1,661	1,605	1,238	2.5%
<b>EBITDA</b>	<b>148,951</b>	<b>165,895</b>	<b>175,859</b>	<b>199,949</b>	<b>187,361</b>	<b>219,652</b>	<b>8.1%</b>
% Margin	27%	26%	26%	27%	25%	27%	

Source: Indiana Lottery Annual Reports/State CAFRs

While the Lottery has experienced some fluctuations in revenue levels over the past decade, the system's EBITDA margin has remained consistently strong above 25%. As illustrated by Figure 4, the primary driver of Lottery revenue growth in recent years has been the increasing strength of Instant games, which contribute an increasingly large proportion of overall Lottery revenues. In FY 2006, the Online games posted higher year-on-year growth with an 18% increase, which was primarily attributable to increased Powerball sales.

## III. INVESTMENT HIGHLIGHTS:

The Authority believes that the Lottery could become the first state lottery in the United States to be managed by an operator through a fixed-term license agreement. While the Lottery is a significant source of cash flow to the State, the State is exploring the possibility that a private entity may be able to create more economic value from the asset while enhancing service levels for Lottery patrons. Highlights of the Lottery include:

- 1. Substantial Barriers to Entry:** The Hoosier Lottery is the only sanctioned lottery gaming system in the State. According to State law, gambling is illegal in Indiana under IC 35-45-5, except as authorized by IC 4-30 (Hoosier Lottery), IC 4-31 (Horse racing), IC 4-33 (Riverboat gambling) and IC 4-32.2 (charity gaming). This tightly regulated market provides the Hoosier Lottery with only limited competition, which in turn ensures strong, steady, and stable cash flows.
- 2. 17-Year Operating History and Highly Recognizable Brand:** Since its inception in 1989, the Lottery has enjoyed steady revenue growth (CAGR of 4.5%) and consistent profitability. The consistency of the Lottery's performance is due to its well-established and highly recognizable brand (Hoosier Lottery), an expansion of its distribution network and a focused marketing strategy that provides gaming opportunities across the State.
- 3. Compelling Revenue Growth Potential:** In FY 2006, overall Lottery revenues increased by over 10%. The continued growth of Instant ticket sales has been critical in driving overall revenue growth, with an 11% increase in year-on-year revenues in FY 2005 and 6.5% increase in FY 2006. The success of new scratch-off games like "Hold 'Em Poker" and "\$100,000 Mustang Mania" also illustrates the significant growth potential in the development of new games. Additionally, recent changes to the structure of the Powerball game have already demonstrated the potential to greatly increase Powerball revenues. Specifically, in FY 2006, one year after key structural changes were implemented, Powerball ticket sales in Indiana increased by 33% to almost \$160 million.
- 4. Operating and Technology Efficiencies:** Significant opportunities exist for enhanced operating efficiencies via the implementation of updated technology, integration with existing operator practices and capabilities, more focused marketing and general cost reduction. The continued application of new technology to the Lottery will help streamline operations and increase efficiency in both the operation of its systems and the development of new games.
- 5. Limited Capital Expenditures:** Because the Lottery is not capital-intensive, much of the uncertainty from the potential wear of physical assets is eliminated, thus making long-range cash flows more predictable. Specifically, the average capital expenditure budget over the past 5 years has been approximately \$1.6 million.
- 6. Resiliency to Fluctuations in Economy and Price:** Not only are Lottery revenues historically resilient to economic downturns, but Lottery expenses also lack exposure to key commodities, thereby reducing the risk of inflation-induced increases in operational expenses.
- 7. Prime Geographical Positioning:** As a participant in the Powerball game, Indiana is able to take advantage of sales to residents in Illinois, Ohio and Michigan, all of which participate in the Mega Millions multi-state game. Residents of these highly populated neighboring states frequently enter Indiana to purchase Powerball tickets.

#### **IV. BIDDER QUALIFICATION REQUIREMENTS AND EVALUATION CRITERIA:**

This RFQ is open to prospective Bidders capable of meeting the requirements highlighted in this section and detailed further in Section V. Upon receipt, all RFQ submissions will be reviewed for completeness in accordance with the submission requirements highlighted in Section V of this RFQ. At the end of this completeness review, the Authority will assess each Team's qualifications, principally in the areas of: (i) technical capability and suitability, (ii)

financial capability, and (iii) social responsibility. There will be no restriction as to the number of Teams that may qualify to bid on the License. The Authority may allow changes in the composition of a Team if the Team is comprised of more than one entity (e.g., joint venture, partnership, etc.); however, any such changes must be approved by the Authority. Failure to obtain such approval may result in disqualification from the process.

### **Technical Capability and Suitability**

The evaluation of technical capabilities and suitability will address whether the RFQ Bidder has the operational capacity to maintain the Lottery at the same or better standards than are currently maintained by the State Lottery Commission.

The Authority requests that prospective Bidders respond with a summary of their, or their sub-contractors', relevant experience in lottery and gaming operations. This experience may include a description of lottery and gaming functions undertaken, details of when and where this experience was obtained, and any references, if available. If the Bidder does not have relevant lottery or gaming experience at the time of submission, it is requested that the Bidder submit a clear plan for developing or partnering with an experienced party by the time of bid submission. As a condition precedent to the transaction closing, the Bidder must have lottery or gaming experience or capabilities deemed suitable to the Authority.

Bidders will be subject to an evaluation of their technical capabilities and suitability to operate the Lottery system. The suitability evaluation will be conducted by the Indiana Gaming Commission (the "Commission") in accordance with the Commission's existing statutes and regulations. These statutes and regulations can be found at <http://www.in.gov/gaming/statutes/>. Bidders who are invited to submit a final bid may be required to submit additional information at the time of suitability evaluation. Commission statutes and regulations may require that certain Team Members and other individuals complete the Commission's Personal Disclosure Form 1 (or other form, as appropriate), which will be provided during the due diligence process.

### **Financial Capability**

The evaluation of financial capabilities will address whether the RFQ submission adequately responds to the financial capability requirements of the License with respect to the following areas:

- Financial capability to pay upfront license fee and ongoing license payments to the State; and
- Ability to raise financing.

### **Social Responsibility**

The evaluation of these areas will address the extent to which that Team demonstrates strong community relations and an ability to work with community leaders on areas of social impact. High ethical standards in the Team's and its Members' conduct of its current business will be expected. In addition, Teams must provide evidence of their willingness to redeploy funds into the community to support educational and social-community infrastructure as well as responsible-gambling initiatives.



## **V. RFQ SUBMISSION REQUIREMENTS AND PROCEDURE:**

### **RFQ Submission Requirements**

Prospective Bidders that anticipate responding to this RFQ shall indicate so as soon as possible by providing contact information via e-mail to both representatives of the Advisor listed below. RFQ submissions should comply with the format provided under "Format and Required Information for RFQ Submission" below. Additional information not specifically related to the License or this RFQ should not be included. *All questions or requests for information regarding this RFQ should be in writing and should be directed to only the representatives of the Advisor as listed below. Prospective Bidders and Advisors SHALL NOT contact any officials or related parties at the State of Indiana or at the Hoosier Lottery. Doing so is grounds for disqualification.*

Mr. Robert K. Collins  
Executive Director  
Morgan Stanley  
Phone: (312) 706-4288  
rob.collins@morganstanley.com

Mr. Emmett D. McCann  
Vice President  
Morgan Stanley  
Phone: (312) 706-4388  
emmett.mccann@morganstanley.com

### **No Liability for Costs**

The Authority, its Advisor and other advisors are not responsible for costs or damages incurred by Bidders, Teams, Team Members, subcontractors, or other interested parties in connection with the solicitation process, including but not limited to costs associated with preparing responses, qualifications, and proposals, and of conducting due diligence or participating in any conferences, oral presentations, or negotiations.

### **Format and Required Information for RFQ Submission**

All RFQ submissions should follow the format outlined below:

- A. Cover Page (to include identification of all Team Members)
- B. Cover Letter (2 pages maximum)
- C. Table of Contents
- D. Executive Summary (Optional)
- E. Team Information
  - a. Description of Bidder: Provide a description of the Team, including a description of all Team Members, the identity of the Key Persons of each party within the Team, and the anticipated legal relationship (governance and capital structure) among the Team Members (e.g., partners, shareholders, client-consultants, etc.), as appropriate. For purposes of this RFQ, "Key Person" means an individual who will have direct operational control over the entity that will be responsible for fulfilling the Team's obligations under the License.
  - b. Roles of Team Members and Key Personnel: Briefly outline the roles of the Team Members and the key personnel of the Team in the proposed operation

of the Lottery system. In doing so, please ensure that all the requirements as detailed in Section IV are addressed.

- c. Contact Person: Provide a single contact person for all future communication between the Advisor and the Team. Please identify the contact person's name, title, organization, address, telephone number, fax number, and email address.
- d. Controlling Interest: Identify the individuals or entities who hold an ownership interest (direct or indirect) of more than five percent (5%) in each Team Member.
- e. Expected Advisors: Identify the companies and individuals who are expected to act as legal, financial, or other advisors for the Team.
- f. References: Provide a list of Team Member references. These references should be able to describe the relevant qualifications and capabilities of Team Members looking to take a leading role in the operation of the Lottery system.

#### F. Technical Capability and Suitability

- a. Operational Experience and Capability: Provide a summary of your Team Members' relevant experience in lottery and gaming operations. To the extent that you do not have specific experience or expertise in such operations, please describe how you would obtain the operational capacity to maintain the Lottery at the same or better standards than are currently maintained by the State Lottery Commission.
- b. Lottery Relationships: Describe your Team Members' experience with lotteries or comparable programs, including the details of any relationship with a state lottery commission, other government-run lottery, or a private lottery.
- c. Gaming Experience: Describe your Team Members' experience with owning or managing gaming activities.
- d. Licenses and Regulation: Identify all jurisdictions in which a Team Member or a Key Person of a Team Member is or has been licensed by a gaming regulatory body, including the dates of licensure. If any Team Member or Key Person has had a gaming license denied, suspended or revoked, please provide details of such matter.
- e. Gaming Ownership: Identify any gaming entity in which a Team Member holds more than a one percent (1%) ownership interest (direct or indirect), and provide details of that ownership interest.
- f. Other Capabilities: If you possess other qualifications that demonstrate your Team's capabilities, please provide.

#### G. Financial Capability

Teams should address the following areas with respect to financial capability:

- a. Financial Capacity to Pay Upfront License Fee and Ongoing License Payments: Teams must demonstrate their financial capacity to pay the equity portion of the purchase price and cover any ongoing payments over the term of the License. To demonstrate sufficient financial capacity, Team Members

must provide copies of audited financial statements for the past two years, together with any other relevant financial information. If audited financial statements cannot be provided, Team Members should provide enough financial information to demonstrate that they have the financial resources to successfully execute a project of this nature and scope. Financial factors which will be assessed include:

- i. Adequacy of entity;
  - ii. Profitability;
  - iii. Availability of liquid equity;
  - iv. Debt/capitalization and interest coverage ratios; and
  - v. Demands from other projects.
- b. Ability to Raise Financing: Teams must provide specific evidence demonstrating their ability to raise financing for a project of this nature and scope. Specific factors that will be assessed include:
- i. Capability of raising debt and equity in the current capital markets;
  - ii. The number and size of past relevant transactions; and
  - iii. Specific experiences on past relevant transactions.

#### H. Social Responsibility

- a. Community Citizenship: Teams must demonstrate strong community relations and ability to work with community leaders on areas of social impact.
- b. Community Reinvestment: Teams must provide evidence of their willingness to redeploy funds into the community to support educational and social-community infrastructure.
  - i. Teams must also demonstrate a strong commitment to devote necessary resources to the issue of responsible gambling.
- c. Ethical Considerations: Please provide details of any past or pending criminal investigation or conviction, material relevant litigation, regulatory or civil enforcement action against any Team and Team Member, or any person holding a 5% or greater interest in any Team Member, or any person identified as a Key Person.

#### I. Legal Provisions

- a. Bidders are advised that materials contained in their responses are subject to the Indiana Public Records Act, IC 5-14-3 et seq., and after the execution of a related contract, may be viewed and/or copied by any member of the public, including news agencies and competitors. Bidders claiming a statutory exception to the Indiana Public Records Act must indicate on their proposal that confidential materials are included and specify which statutory exception provision applies. The Authority reserves the right to make determinations of confidentiality. If the Authority does not agree with the information designated confidential under one of the disclosure exceptions to the Public Records Act, it may either reject the proposal or discuss its interpretation of the allowable exceptions with the Bidder. If agreement can

be reached, the proposal will be considered. If agreement cannot be reached, the Authority will remove the proposal from consideration for award and return the proposal to the Bidder. The Authority will not determine price to be confidential information.

- b. The Authority has adopted many of the required State boilerplate contractual provisions. The Authority hereby puts the Bidders on notice that a successful award at the end of the process will be contingent upon the agreement to comply with these standard contractual provisions (including but not limited to drug-free workplace certifications, minority and women business enterprise compliance, nondiscrimination certifications, licensing standards, certifications relating to HIPAA, certifications regarding telephone solicitations, and certifications relating to State ethics policies.)

### **RFQ Submission Instructions**

Ten copies of the RFQ Submission should be delivered to the address shown below no later than 5:00 P.M. Eastern Standard Time on Monday, January 29, 2007. The Authority may determine in its discretion whether to accept any responses that are not received by the date and time set forth in this paragraph. RFQ Submissions may not be submitted via facsimile machine or electronic mail. Deliver RFQ submissions to:

Mr. Robert K. Collins  
Executive Director  
Morgan Stanley  
440 S. LaSalle Street  
Floor 37  
Chicago, IL 60605  
(312) 706-4288

### **Post RFQ Process**

Prospective Bidders who are deemed qualified by the Authority, in its sole discretion, will be asked to participate in further due diligence as described in Section I, and to ultimately provide final and binding proposals to the Authority for the Lottery. One or more rounds of preliminary bidding or requests for indications of interest may be conducted prior to the request for final and binding proposals. More process details will follow the January 29 submittal.

The Authority reserves the right to modify or terminate this solicitation or the bid procedures at any stage if the Authority determines this action to be in its best interests. The receipt of proposals or other documents at any stage of either the RFQ or the bidding process will in no way obligate the Authority to enter into any contract of any kind with any party.